

# **The Rapid Rise of Supermarkets in Croatia: Implications for Farm Sector Development and Agribusiness Competitiveness Programs**

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Final Version, September, 2003, copy-edited

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## **Executive Summary.**

Croatia's retail sector was largely dominated by socially owned enterprise (SOE) chains (consisting of small-medium stores), small private shops, and green-markets before the transition to a market economy in 1991. In the first half of the 1990s, the SOE chains were privatized, but continued as small-format retailing. Supermarkets made their appearance and developed at a moderate pace, with a strictly domestic capital base, in the second half of the 1990s. A fundamental change occurred in 2001 with foreign direct investment (FDI) in retail, which initiated an explosive race in investments by the various chains. The effect was remarkable: while the share of supermarkets in food retail was only 25% end 2000, it reached 51% two years later, in 2002! For comparison, note that the share in Poland is 40%, France, 70%, and the US, 80%. Croatia thus experienced the same retail transformation in 5 years that the France or the US experienced in 50.

That “downstream” change in the food system had, and is having, major impacts “upstream” in the rest of the food system – on wholesale markets, food manufacturers, and farmers. The proximate cause of that change is the evolution of the procurement systems of the main supermarket chains. We examined that evolution for the case of fresh fruits and vegetables, and found these stages: (1) in the second half of the 1990s supermarkets in Croatia mainly sourced FFV (for their very small produce sections) from informal truck-markets and recently-started wholesale firms serving the newly privatized chains; (2) the latter wholesalers progressively dedicated themselves to the supermarkets needs, and supermarkets shifted in the late 1990s and 2000/2001 toward these wholesalers; the latter also started outgrower schemes to obtain higher quality and more consistent supply of local FFV, and also rapidly increased imports of FFV for the chains; (3) in the past two years, in a crescendo, the main chains are shifting away from (external) wholesalers toward establishing their own outgrower schemes, managed by their specialized wholesalers part of their own holding companies; in some cases the chains have simply bought top wholesalers with major outgrower schemes; the wave of the present and the future is the establishment of systems of preferred suppliers either part of these outgrower schemes or selected outside suppliers.

The chains have a clear preference for farmers and food manufacturing firms that can meet their quality requirements and do so consistently over the year, at minimum transaction costs, with the correct packaging and delivery, and at adequate volumes. The chains thus so far tend to rely on medium (rather than small) farmers who already have greenhouses and irrigation. Where a supplier is promising but does not have this equipment, the leading chains have instituted a new practice of guaranteeing bank loans for these suppliers. This attracts leading suppliers to the chains and gives them yet a further advantage over the wholesalers external to the chains.

The challenges are steep. These new buying conditions and requirements are thus tough challenges for Croatian farmers, who are further constrained by a public extension system not yet geared to helping them meet the requirements of these new dominant buyers, and constrained by lack of credit, skills, equipment, and market information. Through these procurement systems, local farmers suddenly have to be competitive with top suppliers from the region and beyond, and small farmers are in direct competition with medium and large produce growers.

However, the opportunities are also great. Supermarket chains are motors of market development, increasing volumes, quality, and product diversity, adding value, exploring and reaching new consumer niches. Supermarkets in Croatia currently buy 75 million dollars a year of FFV from local farmers in a country of 4.5 million, a very considerable market.

The opportunity comes with an implications for the government, donors, NGOs, and farmer associations. The clear trend is that supermarkets have and will increasingly take over the agrifood sector in Croatia, and “market programs” will increasingly mean “supermarket programs” for farmers, adapting to the requirements of a handful of large chains and some smaller chains competing with them and increasingly imitating their procurement practices. The growers without the requisite skills, information, equipment, and credit will simply be excluded from the dynamic markets in the country, relegated to the least profitable and indeed disappearing market segment that is not yet dominated by supermarkets or by food manufacturers producing for the needs of and to the specification of the supermarkets. Development programs can help make Croatian farmers competitive in their local market, which has suddenly been incorporated into the national, regional, and global market. In fact, it seems very evident that the timetable for helping farmers to make the shift to this new economy may be limited to the coming two years, and that much of the future of who and what is the Croatian **FFV** farm sector will be decided in that time frame."

# **The Rapid Rise of Supermarkets in Croatia: Implications for Farm Sector Development and Agribusiness Competitiveness Programs**

## **1. Introduction**

The objective of report is to analyze the rapid growth of supermarkets in Croatia, their effects on food markets and supply chains, and the implications for agrifood suppliers (farms and firms) as well as project, government, and donor actions to support and improve links of farmers to the supermarket sector. The focus is on fresh fruits and vegetables (FFV) sector.

The study is based on press and literature review and rapid reconnaissance by the team of authors. We undertook 16 interviews and 21 site-visits of supermarkets and other retailers such as small shops and green-markets, specialized wholesalers with and without outgrower schemes, and suppliers, in particular farmers, in July 2003.

The report proceeds as follows. Section 2 focuses on patterns of diffusion of supermarkets in Croatia. Section 3 discusses the evolution of procurement systems of supermarkets in Croatia and their effects on the wholesale sector to which farmers sell. Section 4 draws implications for farmers and for programs assisting farmers to be more competitive.

## **2. Patterns in the Rise of Supermarkets in Croatia**

### **2.1. The Retail and Wholesale Sectors in Croatia before Transition**

Croatia became a socialist country in 1945. Many larger food retail and wholesale firms at that time were converted from private ownership to public, or socially-owned-enterprises (SOE)<sup>2</sup>. In addition, new retail SOEs were formed. In general these retail SOEs handled non-food items and a wide variety of processed foods but sold limited amounts of fresh fruits and vegetables (FFV) – and the latter were mainly imported lemons, oranges, and bananas.

Retail chains created in the 1950s/1960s, included for example Konzum, Diona, Prehrana, Nama, and other regional chains. Each of these also had a limited food products wholesale operation (for example, Prehrana has and had a distribution center in Split) and also sourced from imports mainly from the rest of Yugoslavia but also from elsewhere in the “socialist bloc” states. These chains had a variety of formats and before 1996 they were overwhelmingly composed of small/medium shops with some department stores, and a sprinkling of small supermarkets that were located in cities and towns.

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<sup>2</sup> Socially owned enterprises were technically “owned” by their workers. Although not formally state enterprises or subject to State Plans as in the former Soviet Union, the State directly influenced SOEs through the state controlled banking system and the hierarchy of the Yugoslav Communist Party.

By the early 1980s various agrokombinats (large agricultural production and marketing SOEs) had opened retail outlets that primarily featured their own products; examples include Gavrilovic (meats), Podravka (processed vegetables), and others such as IPK Osijek, Belje, PIK Vrbovec, Jasinje. Voce and Dona, vegetable production agrokombinats, also had their own shops.

Outside the SOE sector were the green-markets (trznice) that were built and operated by municipal governments. Most FFV was sold through these markets while most processed products and staples were sold through the SOE chains. The green-markets primarily supported farmers selling their own products at stands leased from the municipality and were located in towns and urban areas. By the mid 1980s wholesalers, operating either as individual traders or as small private companies began to lease stalls at the green markets, thereby expanding the product line offered through this retail channel.

A major structural transition occurred in the retail and wholesale food sector after the 1990-91 transition period following political independence and “de-socialization” of the economic system..

## **2.2. The Retail Sector after the 1990-91 Transition Period**

In this subsection we focus on the retail transformation after the initial transition period from a socialist to a market economy. We can distinguish three relevant periods, immediate post-transition, 1991-95, an intermediate phase, 1996-2000, and the “hyper-growth with globalization” phase 2001 to present and beyond.

During 1991-95, many retail SOEs were privatized and many independently owned small retail shops selling FFVs were also established. Many were founded by people who lost their jobs during the 1990-1991 transition period, using personal savings. These small retail shops declined rapidly after 1996 as the retail chains began to exert their influence.

Various private chains were also started during this period. For example, Prehrana was privatized, and Alastor (a regional chain based in Osijek) and Kerum (a regional chain based in Split) were launched immediately during the early post-socialist reforms. These chains were in this first phase still overwhelmingly “small format” during this period (that is, nearly all sales were in small/medium shops of less than 300 square meters).<sup>3</sup>.

In 1994, Getro Ltd was organized as the first cash and carry and discount store opened in eastern Zagreb with 8,500 m<sup>2</sup> floor space. In addition, it contained a large retail sales area that included FFV, meat, baked goods and some non-food items as well.

Unikonzum, a privatized former SOE chain based in Zagreb, was purchased in 1994 by the giant Agrokori, a multi-product holding company that includes many food product enterprises. In 1995, the name was changed to Konzum and the first western style supermarket was opened in Zagreb.

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<sup>3</sup> Note that a supermarket in Croatia is generally defined to be from 400 to 2500 square meters, although CBA, the Union of Independent Retailers, classes supermarkets starting from 300 square meters; here we use the 400-2500 square meters category as our definition for supermarkets.

This mirrored an approach from the pre-transition period, where a production-based enterprise expanded downstream into retailing. We will see this again in August 2003, below. Many of the privatized SOEs floundered in the ensuing decade, for reasons including a lack of capital investment, insufficient working capital, and excessive overhead costs mainly associated with their inability to shed a largely redundant labor force. The continuing Balkan war that lasted through 1996 also contributed to the generally poor economic climate. A major exception of course was Konzum that survived to become the leading chain today.

Continuing the trend established during the socialist period, FFV sections in these newly privatized or privately established chains were, with few exceptions, tiny or non-existent. Managers assumed nearly all consumers wanted to buy most fresh food in the green markets and confined themselves to processed products. During this period traders operating in the gray economy, and not paying taxes, came to dominate the green market sales. The variety and quantity of FFV greatly increased and the quality improved due to expanded imports of FFVs from European countries such as Italy and Spain with tropical fruits coming from Africa and Asia.

Starting in 1996 but before 2001 (the year in which foreign chains came to Croatia) the retail system (but not yet the wholesale system) rapidly changed, with the key points as follows.

First, some of the chains formed large-format food-focused stores. We say food-focused because before this period most department stores in Croatia were large-format but mainly non-food (clothing, etc.). Based on the Getro and Konzum supermarket formats regional chains such as Alastor in Osijek and Kerum in Split went to the supermarket format by 1997. During this period the Konzum chain opened a number of Konzum-maxi stores (small supermarkets) and several Super-Maxi stores, large supermarkets. Konzum opened its first cash and carry store in Zagreb in 1997.

In this second half of the 1990s, supermarkets grew gradually (compared to the explosive growth in the early 2000s). They were locally owned and expanded mainly in the upper and middle income neighborhoods of the larger cities (Zagreb (now 1 million), Split (now 500k), Rijeka, Osijek (now 120 k)). For example, Getro opened its second cash and carry store in Zagreb in 1998, with supermarkets being opened in Osijek and Rijeka in 2000. There were as yet no foreign supermarkets, and the dominant chains were Konzum and Getro in Zagreb, Euroviba in Split, and Alastor in Osijek.

During the 1990s, the influence of the Agrokombinat-supported FFV retail sector almost completely disappeared as the same factors that led to the downfall of the retail SOEs also affected these enterprises.

A major change in food retailing started in early 2001 and continues to today. Most of our interviews mid-2003 with supermarkets were decidedly marked by the phrase, “starting two years ago...” as the cusp of extremely dynamic change in the Croatian supermarket sector. The prior gradual growth and the recent growth spurt were driven by several factors some of which are common to most experiences of development of supermarkets. (1) Incomes grew over the past decade. (2) Urbanization proceeded over the past decade. (3) There was an increase in public and

private transport and road development (road networks nearly doubled in the past decade as did the number of vehicles). (4) A better and more stable foreign investment environment developed especially since 1997. (5) The prior investment in SOE retail chains laid a base for development of private supermarket chains, and Croatian consumers were already used to shopping in chain stores, albeit small format before the mid 1990s. (6) While women already represented nearly half of the workforce in 1992 (as in 2002), there was a shift in women's employment toward more skilled work outside the home in trades and commerce, with what was probably a concomitant increase in the opportunity cost of women's time.

Several characteristics of the current rapid growth should be noted.

First, there was extremely rapid growth of the supermarket sector over 2001/2002, among the fastest in the world. The share of supermarkets, hypermarkets, and cash & carry<sup>4</sup> stores went from nearly nothing in 1995, to 22% at the end of 2000, to 51% at the end 2002! (Excluding the cash & carry stores, the share went from 18 to 43% over those two years.) The share of supermarkets in overall food retailing is similar, at 50% in 2002 (GfK, 2003). This share can be compared with 25% in Honduras, 50% in Chile, 40% in Poland, 70% in France, and 80% in the US. The penetration of supermarkets in Croatia's food retail thus went from that of a poor country to a middle-income country... in only two years. If that is not a world record of growth, it is one of the top growth performances observed in retail history. Supermarkets (and with an increasing share in overall large formats, hypermarkets) are suddenly the major way that Croatians shop.

The current level of supermarket development in Croatia is quite comparable with that of the middle-income country Chile. Although the store-rate is lower (because of a greater incidence of hypermarkets and larger supermarkets in the supermarket-sector), 44 supermarkets per million in Chile, Chile's per capita income is the same as Croatia's, and even though supermarket development started a half-decade earlier than in Croatia, Chile's supermarket share of overall food retail is also at 50% (meaning of 100 dollars spent by a Chilean consumer, 50 are spent in supermarkets).

Second, the inevitable accompanying trend is a sharp decrease in the number of small shops in a short time. Small shops dominated food retailing in Croatia until very recently: in 1999 they had 70% of overall retail trade but that share dropped to 45% by the end of 2002. (Note that apart from small shops, with 45, and supermarkets, with 51%, the green-markets and street vendors constitute the balance, 4%, with these three categories summing to 100% of the food retailing sector.) In 2002 alone, 4500 small shops closed their doors and shuttered their windows for the last time (GfK, 2003). There is casual observation (from our interviews) that the green-markets have also declined markedly over the past several years as the share of FFV in supermarkets has risen.

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<sup>4</sup> Cash & carry stores are large format stores that sell to retailers, and are thus wholesalers, as well as sell in the same store to consumers, and thus are also retailers (for Metro in Zagreb for example the shares are 40/60 for those two functions, per store).

We lack specific data on FFV cash expenditures by Croatian households by retail category. It is probable that the share is below the 51% share of supermarkets in all food retail (because usually growth in supermarkets' share of FFV retail lags that of total food retail). However, we calculate that Croatian supermarkets sold very roughly 2 billion kuna<sup>5</sup>, or 250 million US dollars of FFV in 2002 per year, a large market for a country of 4 million. Given that roughly 30% of FFV retail by supermarkets is Croatian FFV that means a market for Croatian FFV farmers of roughly 75 million dollars per year.

Third, by international standards the Croatian supermarket sector is not yet very concentrated – although from the point of view of those interviewed the retail sector “feels” concentrated for several reasons. (1) Up through the 1990s the retail sector, be it in supermarkets or small stores, was very fragmented and “local”. (2) There emerged a front-runner among the local domestic chains, Konzum, to 20% of the supermarket sector, as it spread from Zagreb to the other regions, and from 200 to 500 stores (with a mix of small stores, supermarkets, and hypermarkets), and to be trending toward a 25% share in 2004. Konzum moved beyond its “traditional home” of Zagreb and bought formerly dominant regional chains in central points of the crescent-shaped Croatia: Euroviba in Split in 2001 and Alastor in Osijek in 2003. Just these moves by giant Konzum give the feeling of an immediate concentration in the sector. (3) Several foreign chains have entered Croatia in the past two years, that are important quantitatively in the sector, but are also “larger than life” in the following sense: the sudden appearance of major global retailers such as Metro or regional actors such as Billa inspires over the food retailing sector, and wholesalers and producers working with them, the feeling of intense competition and imminent further concentration.

Fourth, both a sign of the response to incipient concentration combined with further impetus to concentration is the response of the smaller chains (usually composed of a mix of formats including supermarkets). They have responded to the challenge of the rising share of the major chains (such as Konzum, Billa, Metro) of supermarkets and hypermarkets by forming a union of “independent supermarkets” similar to the origins of Edeka (which started as a buying-union of supermarkets and then fused into a single company) in Germany or a decade ago a similar union in Hungary. The unions in Germany and Hungary have joint procurement for a subset of their products (in particular, dry/processed foods that can be bought from a few large firms and the prices of which are relatively stable and negotiable from a central point – unlike the current situation for FFV at general wholesale level in Croatia, as discussed further below).

Thus, 18 months ago, 11 chains formed a “union” (a buying union) with a central company called CBA International d.o.o. CBA comprises 450 stores among which are small shops, supermarkets, and hypermarkets spread over Croatia. CBA is initiating some joint purchases for its members, in particular for several processed items; it has not, and noted to us in the interview, that it hopes to but will probably not for several years have the capacity to centralize FFV purchases.

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<sup>5</sup> This rough estimate is based on the fact that Konzum sold 400 million kuna of FFV in 2002 (based on our interview), and Konzum has a 20% share of the supermarket-sector. Five times 400 gives the 2 billion figure, which might be somewhat of an overestimate as not all chains have as high a share of FFV in their sales as does Konzum. But the estimate gives a rough order of magnitude.



A different kind of union just formed to start a new chain in August 2003 – but this time a union of food processors including Lura and Vindija (milk processors) and Podravka and Gavrilovic, (vegetable and meat processors) among others, to buy the bankrupt chain Diona, a former SOE that was privatized in the 1990s. These companies are major creditors of Diona and by trading debt for equity are moving into the retail food sector from their position as major food processors. The revamped Diona might then give the processors further outlets, as well as provide leverage in dealing with other chains.

Fifth, by international standards the Croatian supermarket sector is not yet very multinationalized (that is, the presence of foreign chains). But multinationalization started very rapidly two years ago, when foreign firms perceived the investment climate in Croatia to have improved and stabilized. From 2001 to now, Billa, Kaufland, and Metro entered from Germany, as did IperCoop from Italy, and Mercator from Slovenia.

These chains entered and began immediate expansion: for example, Metro opened a large hypermarket in western Zagreb in 2001, another in eastern Zagreb in 2002, and is opening one in Rijeka (coast) in October. Each of these turns over roughly 80 million dollars a year, so this is a rather sudden quarter-million dollar presence in a retail sector of a country of 4.5 million people. Another way to look at this is to note that the 46,000 small shops on average sell about 125,000 dollars per store per year. That means that the 3 Metro hypermarkets – the equivalent of 2000 small shops! The German chain Kaufland (part of the giant Lidl chain) opened 6 supermarkets in Croatia in the past year, will open 7 more by end 2003, and another 8 next year, a rapid expansion. The Italian chain IperCoop opened a hypermarket in Zagreb and just opened another in Osijek and is opening another on the coast.

Moreover, SPAR, another cash & carry-hypermarkets chain (from the Netherlands) and LIDL (a low-price retailer from Germany) are (with high probability as they have already picked out real estate) entering in 2004. Competition in the retail sector is already “red hot” and these entries will move it to “white hot”.

Sixth, the rapid rise in overall numbers and retail market share of supermarkets in Croatia is accompanied by a pattern of spatial diffusion that looks like ripples going out from large rocks dropped in three or four points in a crescent-shaped pond. Although Zagreb has a quarter of the country’s population, the fact that SOE and some large private retail chains were rooted in major cities around the country (Zagreb, Split, Osijek, Rijeka, a few others) meant that there were the seeds of domestic chains in several places – and as competition increased, each had an incentive, and a subset of them had the capacity to the following. (1) They made the leap to other major cities in order to have a national presence in retailing (and like clockwork as we show below this was followed with a national presence in wholesale distribution as well). Examples of these inter-spatial investments are noted above; until now, foreign chains such as Metro, Billa, and Mercator have focused on the lateral leaps of this first kind, focusing on large urban areas, and not the second kind of diffusion that we note next. (2) They radiated out from the major city first into intermediate cities nearby and then into towns, even towns as small as 15-20 thousand. For example, Alastor started as a chain of small shops in Osijek, the largest city (120k) in eastern Croatia near the Hungarian border in the grain and livestock belt, and then started supermarkets in

the late 1990s and quickly built a chain of 14 supermarkets, first several in Osijek, and then in larger towns around, and finally this past year into small towns such as Dakovo (20k population). Konzum then acquired Alastor this year and so simultaneously made the leap from Zagreb east, and from Osijek to its rural area towns. A similar set of moves occurred when Konzum entered Split through acquisition of Euroviba in 2001 and then in the next two years spread out into rural towns such as Sinj (20k).

Seventh, the above diffusion of new retail types (new relative to the traditional small shops and green-markets) has occurred with a diversification of and shift in formats. The patterns in general follow earlier international experiences. The early development (in the second half of the 1990s) of large format was focused on the proliferation of small-medium sized supermarkets near city centers (with some exceptions, where the keystone store was larger). This was followed by the development in the early 2000s of larger supermarket and hypermarkets in the outskirts of large cities and small supermarkets in smaller towns. There is incipient development of convenience store formats but it seems as if there is not much “room” for this format given that the earlier chains were close to this format, unless they appear as straight substitute-competitors for the present chains of small stores. To now there is little presence of medium-sized large format discount stores, but Lidl’s entry will change that. In other countries, the entry of chains such as Lidl, or Carrefour’s DIA, have brought to the retail sector the image of supermarkets that was captured in their popular name at the start of supermarket development in the US in the 1930s: “price wreckers”. That will take supermarkets the remaining distance into the bulk of the rest of the Croatian consumer segments relatively less touched by supermarkets so far, the poorer and small town segments.

The upshot of the above is that in the space of only seven years, supermarkets have started and developed at remarkable speed in Croatia, leaving far behind the traditional retail food system. In a mere half decade, supermarkets went from a small niche, an inconsequential minority, in a few large cities, to a spatially and socioeconomically widespread phenomenon, already 50% of the retail sector – which means that today, 5 out of 10 “food kunas” are spent... in supermarkets.

The procurement systems to obtain that large volume of FFV generated by the above remarkable supermarket growth are discussed below, and their deep implications for Croatian farmers and markets.

### **3. Wholesale Sector Transformation post-Transition, with a focus on the evolution of supermarkets’ procurement systems**

The evolution of wholesale systems post-transition roughly follows the three stages we noted above for retail transformation, so we retain those phases to structure our discussion below.

#### **3.1. Early Post Transition**

During roughly 1992-1996, before the major expansion of supermarkets in Croatia, wholesale markets for FFV generally continued as before the transition, basically as “truck markets.”

However, a few specialized FFV wholesalers emerged. For example, Bili Commerce and Vrni, both based in the coastal FFV production zones, began to serve the newly privatized chains such as Diona and also provided FFV to the military operations. Bili for example focused mainly on the Diona and Konzum chains of small stores, and on importing for UN peace keeping forces. Several regional outgrower schemes cum wholesalers also emerged to mainly supply green markets and small store chains. Examples include Alastor (the case of Vesna in Osijek, who started as a small wholesaler and then grew into a major wholesaler in that region), Fragaria, an apple supplier that gradually increased its wholesaler and outgrower-management functions, and Gomolava, a major importer-wholesaler.

### **3.2. Era of the Emergence of Supermarkets, 1996-2000**

The character of the FFV wholesale system rapidly changed with the first supermarkets but before the arrival of international chains. At first supermarkets mainly sourced from truck markets, traditional wholesalers, and the few new wholesalers mentioned above. The wholesalers selected and delivered to stores the mixes of products they wanted. The volumes per store and chain were very minor at that time. The Konzum chain mainly of small stores and then several supermarkets carried little FFV at that time, as did the regional chains such as Kerum and Tommy at which only about 1% of sales at most were in FFV. Thus, at their nascence, Croatian supermarkets had very little effect on the wholesale system and traditional wholesalers could easily handle their small procurement needs.

### **3.3. 2001-2003: Skyrocketing Supermarket Growth and Deep Change in their Procurement and general Wholesale Systems**

As noted above, this was a period of extremely fast increase in the number of domestic chains and supermarkets and especially of foreign direct investment (FDI) in large-format retail food sales outlets.. The competition in terms of costs for the first 1-2 years and then in quality in the past year made itself strongly felt on the FFV economy of Croatia. There was a universal feeling (among those interviewed) that the truck markets / traditional wholesale markets could not deliver the required quality, and there were high transaction costs and foregone margins when supermarkets had to rely on them. This was mainly true of the traditional markets and brokers, but the chains also had that feeling, in particular with respect to the lament of foregone margins, about the “new wholesalers” mentioned above who had emerged during the early post-transition.

To respond to the need felt by the chains for alternatives to the existing wholesale system, there was a rapid rise of specialized/dedicated wholesalers of several types.

First, outgrower schemes (that also completed with imports off-season or for products not available in Croatia or available but not enough) expanded rapidly and shifted their focus from other markets to the supermarket-market. Sometimes these were already dedicated to one or more chains; the wholesaler/outgrower then shifted in the past several years from mainly selling to

green-markets and chains of small stores, to selling to supermarket chains. That was the case of the outgrower schemes Vesna in Osijek (focused on Alastor), DAD in Neretva (focused on Konzum), and to a certain extent also for the “new wholesalers” who had emerged in the earlier eras (Bili). The first two, Vesna and DAD, were mainly outgrower schemes that then added wholesale schemes to be “one-stop-shopping” for the chains. Bili also grew quickly, from 30 outgrowers in 1992 to 300 in 2003, and from 1998 to 2003 moved from dedicating 10% of its volume to supermarkets to 50%.

Second, there was rapid expansion of suppliers such as Fragaria or Vrni or Lipovac who mainly had their own production and who had then recently substantially added outgrowers to increase volume and also had added more wholesaling functions and value added operations. Hence, these supplier-wholesalers shifted toward specializing in supermarkets and adding volume and assortment so that they could be one-stop shopping for supermarkets at least in several categories per wholesaler. All three of these grew very quickly; the largest of them, Lipovac with a farm near Osijek and a distribution center near Zagreb, grew from 300 to 3,000 ha of outgrowers in only the past three years! Vrni started in 1996 with 3 ha of its own production, 10% of the output of which it sold to supermarkets. Over the past 6 years it then added 68 ha of outgrowers, and it sells 70% of its output to supermarkets.

The largest chains began recently to acquire the specialized wholesalers in order to have their own “preferred supplier” program and accomplish three goals. (1) They cut out the margins of the middleman (this was emphasized as a key goal by the retailers, such as Konzum and Metro.) Konzum acquired DAD (by far the largest outgrower scheme in the coastal fruit and vegetable areas) and then Vesna (ditto, but in the Slavonia area) in the past year in order to gain control of the supply channels. (2) The chains sought to obtain the quality they want and begin to cut procurement costs to increase profit rates and also increase year-round consistency so that there are fewer breaks in the supply over the year. (3) The chains wanted to greatly increase the volume of throughput, and via outgrower schemes controlled by them, to vastly increase local production. This was needed to fuel the immense increase in FFV sales that they sought and succeeded in accomplishing. For example, Konzum went from 70 to 400 million kuna of FFV sales in the past two years! The dominant retail chains also rapidly began to supply FFV to food service companies such as restaurants and hotels that formerly were almost exclusively supplied by the specialized wholesalers.

The preferred supplier programs of Konzum (DAD, Vesna/Fructus) emphasized grower upgrading with greenhouses and irrigation as key. The chain seeks to reduce the sharp seasonality of production (a major problem revealed in all the interviews) and increase product quality. Konzum (and now Metro) are unique in that they have the very deep pockets needed to guarantee loans for capital investment of their outgrowers, to acquire greenhouses and irrigation. In interviews with competitors such as Bili and Vrni, it was emphasized that this put other wholesalers at a steep disadvantage in the present situation of extreme competition for good local growers and market share.

The larger chains have also in the past two years been investing in large distribution centers (DCs). Konzum opened the largest DC in the former Yugoslav region in 2000. DCs allow a

major cut in costs. While we do not have estimates for this in Croatia, in Brazil and Costa Rica the cost cut for moving from per-store delivery to use of DCs is a huge 30-40%! There is usually a “turning point” where chains make this shift, at the point where throughput justifies and turnover/financing allows this shift. In Brazil for example this is at 2000 tons/month. Konzum has shifted rapidly toward a network of such DCs replacing costly shipments, delays, and coordination costs relative to its earlier system of many smaller warehouses, which dealt at smaller scale of activity. Konzum interestingly has not centralized physical procurement, in fact they moved the opposite way, toward decentralization, using a set of DCs as a base for shifting from a regional (Zagreb) to a dense store pattern over the “crescent” shaped Croatia in just two years, providing the equivalent of a major DC for each major area of Croatia. Similarly, Metro is planning to build a large DC following its new Coastal store in October 2003. Billa had planned to wait until it had 20 stores in Croatia before building a DC, but because of competitors’ moves it has cut in half the waiting time and is now doing starting a large DC.

By contrast, and this illustrates the mechanisms that increasingly differentiate the competitiveness of dominant and secondary chains, CBA noted that they are at the disadvantage of not yet being at the stage to have a DC or system of DCs.

The importance of this shift to DCs by the dominant chains is that it reduces the need for wholesalers to provide extensive trucking/transport of produce to individual stores or warehouses. Konzum for example is investing in its own fleet of trucks. By contrast, Fragaria said it had consciously avoided investing in a large truck fleet because they predicted the shift to DCs and thus the fact that traditional wholesale services demand would drop quickly. Interestingly, Lipovac is investing in a large fleet of trucks in order to serve the smaller chains and CBA which it knows are the residue (the last of the species) of retailers who will need these services, but need them they do to compete with the larger chains who have jumped in efficiency by being able to provide these for themselves at large scale.

Moreover, chains, in particular the foreign chains with regional operations, are beginning to take advantage of their regional (and probably eventually their global) character through international or extended regional procurement systems that acquire the cheapest and best quality products from the various countries, applying “absolute advantage” theory over countries. Metro is setting that up over the next year with a Southeast Europe Business Unit that will serve the Metro stores in the sub-region sourcing from the whole sub-region. That follows a similar practice for example by Ahold in northern Central Europe (Ahold Central Europe is the counterpart for them) and the East Coast of the US, or what Carrefour does in Southeast Asia, and so on.

The general tendency observed among retailers is the following.

The front-runners (Konzum, Metro) are very rapidly shifting or have shifted already toward a preferred supplier system (see above) which includes a combination of a heavy reliance on their own outgrower/managed schemes (Vesna/Fructus and DAD) which provide the great majority of Konzum’s domestic produce, plus their own managed imports. Metro is shifting rapidly toward its own outgrower scheme, already in place, with plans to expand it rapidly over the next year. For both Konzum and Metro this means displacing specialized wholesalers they were using. Konzum

already dropped Fragaria and Bili in the past year and replaced them with their own outgrower schemes/wholesalers, as well as with specialized suppliers such as Lipovac that has risen very quickly as it displaced more traditional wholesalers who were not specialized suppliers that added value. Fragaria noted that its business was entering a second phase and shifting from dedicated wholesaling toward high-quality contract production for specialized niche buyers. In addition where the large retailers were leaving niches for those outside their own outgrowers, companies such as Lipovac (which provides a specialized set of fresh or frozen vegetables) or Podravka, (which processes high quality vegetables and fruit) are able to meet this demand.

The smaller regional chains that are vying for competitive status in FFV such as Tommy on the coast (with rapidly growing share of sales in FFV and expanding chain) are shifting toward preferred supplier systems. The smaller regional chains still have a much smaller share of FFV (Kerum only has 3%, and CBA chains) as well as the smaller national chains (Billa, Getro) still rely heavily on the main wholesalers and suppliers cum wholesalers (Bili for example) but the share of these smaller chains is dropping in national retail as consolidation quickly proceeds, so the market is being cut out from under the wholesalers.

#### **4. Lessons For Farmers And Those Who Assist Them**

First, the dominant FFV buyer that the farmer faces is the supermarket chain (directly or through a wholesaler working mainly for the supermarket); Konzum is the largest produce company in Croatia now, and most food is retailed by supermarkets. With the steady decline of greenmarkets, supermarkets will soon be the major retailers of fresh produce.

Second, those buyers are in extreme competition with each other on costs and quality and are organizing their procurement systems to give them every bit of advantage they can get.

Third, the wholesale system faced by the farmer for many years has very suddenly changed a lot and will change much more yet. There has been a rapid decline in the truck market/wholesale system, and a minor increase in formal wholesale markets. There was rapid rise and then the solid start of the decline of new general wholesalers, the rapid rise and then acquisition by supermarkets of the specialized wholesalers, and the very solid start of a rapid shift toward a tight system of preferred suppliers (in outgrower schemes and in specialized supplier companies like Lipovac and Fragaria).

Fourth, not all the buyers (retailers/wholesalers) are following the new changes, they don't have the means. These enterprises represent options for smaller producers who are not yet ready to compete for a spot in the high quality markets – but they are only temporary options because they will likely be competed out of the market or purchased by the leading retailers or their wholesale units.

Fifth, Croatian suppliers are no longer in the segmented supply market, that was de facto protected by fragmented markets and poor private and public infrastructure a mere decade ago. They are now competing at least in a national market knit together by nationwide procurement systems of the front-runner chains, that are exposed to foreign competition. (Retailers, for

example, have organized a huge flood of imported apples, tomatoes, and stone fruit, garlic, and even many greens, from Greece, Italy, Spain, South Africa, Argentina, Chile, China, you name it. 70% of FFV is now imported, and even though the preferred supplier systems locally will doubtless decrease that share, the supermarkets have simply been very powerful motors to import and sell fruit and even vegetables from other countries. They are gearing up to do this even more effectively at a subregional level, with Metro and probably Mercator and others organizing this.

Sixth, the regional and even the global markets that have thus come into the local market most effectively through the supermarkets (much more quickly and further than it would have happened without them), require procurement systems that are – in principle – a two-way street. That is, Croatian suppliers can use regional procurement systems of German, Slovenian, and Austrian companies to identify and facilitate exports out of Croatia. Some of these chains already have specific plans and actions underway to do this; and Croatian farmers should be helped to take advantage of this opportunity

Seventh, this potentially good news is reinforced by one interviewee after another saying that they want to buy more local products, especially seasonal niche/perishables like strawberries and good quality greens that are costly to import and are best when local and very fresh. Supermarkets want product diversification, quality increase, and value added products – but at internationally competitive prices.

Finally, this study revealed that the great majority of farmers are not in fact ready for the amazing transformation of the market that has occurred right under their feet in 3 years. Most buyer-interviewees said that Croatian farmers supply “gluts” of seasonal products for a few months and then leave them stranded the rest of the year. They supply products with large variability of quality, they are hard to deal with due to poor organization and commercial practices, and they cannot enter enforceable contracts with them due to lack of good legal systems. Moreover, farms are so small that to get adequate volumes they have to deal with many small players not organized into effective groups, and the great majority of farmers lack what buyers are desperate for them to have, greenhouses and irrigation to improve timing, quality, and consistency.

The tough truth revealed in the interviews is that the supermarket-buyers do not think that public extension programs as they are structured and focused at present are of value in preparing farmers for the new challenges. These supermarket buyers have simply designed, in their preferred supplier and outgrower systems, substitutes for public systems, replete with credit, technical assistance, packaging assistance, and other needs of farmers that they see are not met by public systems.

There is already a rapid convergence of standards between Croatian and European retailers, hence standards facing suppliers – and all this well before Croatia formally “enters” the European Union. In fact, it seems very evident that the timetable for helping farmers to make the shift to this new economy may be limited to the coming two years, and that much of the future of who and what is the Croatian FFV farm sector will be decided in that time frame. Government and donor strategies will play a role if geared to that urgent timeframe – and take into account that a FFV market strategy is today a supermarket strategy.

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